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ZNR UUUUU ZZH
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FM AMEMBASSY RIGA
TO RUEHC/SECSTATE WASHDC PRIORITY 5891
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHZL/EUROPEAN POLITICAL COLLECTIVE

UNCLAS RIGA 000326

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD PGOV LG
SUBJECT: GOL REACHES CONCEPTUAL AGREEMENT ON BUDGET CUTS

Ref: Riga 318

¶1. Summary. Government coalition parties and key social partners have agreed in principle to cut the central government budget for 2009 by 500 million Lats ($1 billion USD). The decision is limited to setting a target level for budget cuts, and specific budget cutting measures will be decided upon in the coming days, with the plan still to finalize the budget in parliament June 17. Latvia's donors (primarily the IMF, European Commission and Sweden) now await specifics to determine if the government's proposed cuts are real and substantive, with further disbursements of IMF and EC money hanging in the balance. Achieving these cuts will be difficult and the time short. As former President Vike-Freiberga said "the government proposes to do in ten days what it should have been doing over the last three months." End summary.

¶2. Following local government and EU parliament elections, President Zatlers convened key players to hammer out an agreement on the budget to ensure continued international financial support. Governing coalition parties together with key social partners (labor unions, the Latvian Chamber of Commerce, the employers' confederation, and representatives of local governments) agreed in principle to cut the government budget by 500 million lats (roughly $1 billion USD). The agreement is not binding, and cannot be interpreted as a clear signal of unity among the involved parties. Realizing the inevitability of the cuts, social partners chose to go along to avoid being left out of the negotiations. The government has decided that with ever growing contractions predicted, hitting a specific deficit percentage target as envisioned in the original IMF plan was too hard and decided instead to do fixed cuts. The specifics of the cuts remain to be agreed in cabinet sessions and in meetings of a newly-formed "Crisis Working Group," headed by the Prime Minister, and including representatives from the social partner organizations. In advance of detailed talks, though, the government announced its intention to introduce a progressive income tax system, reduce the amount of earnings that are not taxable, increase VAT from 2010, decrease the minimum wage, and cut central government employee remuneration by at least LVL 120 million ($240 million).

¶3. The social partners tell us that they will strongly oppose cutting social spending, including retirement pensions, funds for EU project co-financing, and directly or indirectly shifting the burden of budget cuts to local governments. A view shared by all of the organizations is that the majority of the cuts can be made in the administrative budgets of ministries, with the local government association stating that as much as two-thirds of the total target amount can be made through administrative spending reductions. From inside government, we hear reports that ministries are planning for further across-the-board cuts rather than targeted, strategic plans for reductions. The chamber of commerce has already announced strong opposition to raising the VAT and disagrees with the Finance Ministry's revenue projections, stating that future revenues cannot be accurately forecast in such a complex situation.

¶4. Comment: The decision to make such profound fiscal cuts was generally welcomed by international donors and the financial press, but all key players have stated that they await concrete proposals

on how the government will reach the 500 million lat target. After all, the government has announced several plans for major cuts since January, but little action has occurred to date. As one newspaper said, "It was as if Finance Minister Repse woke up after local government elections in an entirely new government, which he suddenly discovered had done nothing in the previous two and half months." If the government can demonstrate budget reductions that are substantive and represent a strategic restructuring of government functions, it is likely that investor confidence will be restored and international donors can proceed with agreed disbursements of Latvia's financial assistance package.

¶5. Comment continued. However, Latvians may read EU Commissioner Almunia's comments to the press on June 9 as affirmation that it is only the amount of cuts, not the sustainability of reductions or the quality of structural reforms that matter. If the government does not satisfy investors and donors, the State Treasury can only maintain government spending into July. As one editorial noted, failure to satisfy donors and investors now could lead to a worst-case economic scenario, and such a meltdown would likely lead to special parliamentary elections, which none of the coalition parties want to see after their dismal showing in the June 6 local and EU elections. One the other hand, an honest and thoughtful attempt by the coalition to make the tough decisions needed in the next week could be the positive signal that gets the government through the rest of this year, and into 2010 when economic activity may improve.

Rogers